Surprises, resilience and central banks

The publication of Q4 economic activity data has confirmed that the global economy closed last year with a much better combination of growth and inflation than had been anticipated at the beginning of the year. In countries such as the US and Spain, average growth in 2023 stood at 2.5%, whereas 12 months ago the forecast according to the analyst consensus placed it in the 0.5%-1% range and a recession in the US was considered highly likely, supported by signals such as the inversion of the yield curve slope. Similarly, on the inflation front, the trend in recent months has been much more benign than most projections, thanks to the fading of the energy shock and the gradual disappearance of its indirect effects, pending confirmation from the wage data that the second-round effects remain under control.

Therefore, in an environment characterised since 2020 by a string of negative disturbances, the positive surprise in 2023 was once again the resilience of the global business cycle, understood as «the ability of a living being to adapt to a disturbing agent or an adverse state or situation» (the first definition of «resilience» according to the Royal Spanish Academy, the authority on the Spanish language). As the chair of the Fed himself recently acknowledged, it is very unusual from a historical point of view that the monetary tightening implemented in the last two years has not had a much greater impact on economic activity and, above all, on employment. In this context, it is understandable that the central banks have not used their latest meetings to try to counteract (or at least not decisively) the significant easing of financial conditions observed in recent weeks, which indicates that investors are anticipating an immaculate disinflationary process. The latest inflation data speak for themselves and reflect both the improvements on the supply side (beyond short-term shocks caused by geopolitical risk) and the speed with which the monetary tightening process has been transmitted to demand this time through the credit channel.

The question is what could alter the roadmap that the financial markets are anticipating for the central banks. Beyond the ever-complex calibration of geopolitical risks (with the inscrutable Trump factor hovering over the medium-term outlook), the unexplored territory of the last mile in the fight against inflation and the effects of sectoral and regional cyclical divergences (they ought to be reduced in this first semester), the biggest risk for economies such as the US is that they could end up dying by success and go from a soft-landing scenario to one with no landing at all. This is not our central scenario, but the reality is that the recent growth of GDP (4% annualised in the second half of 2023) and employment (almost 3 million jobs in the last 12 months) are clearly above their potential rates, no matter how optimistic we may be about the effects of artificial intelligence on productivity. For now, the steady drip of positive economic activity data in the US has only led the markets to push back the date when they expect the Fed to make its first rate cut, from its March meeting to that of May or June. This delay has also entailed a reduction in the cumulative declines that are expected for 2024 (from 150 to 100 bps) and a correction in debt yields of around 20 bps since the start of the year, following the rally in November and December. This movement has also occurred in Europe, in this case primarily driven by the reluctance of core members of the ECB Council to allow their arms to be twisted so soon, rather than a lack of improvement in the economic activity data.

In short, with the outlook of rate cuts now incorporated into the markets' radar, the questions going forward will focus on what path the monetary normalisation process will take and what level rates will end up at. The options are either to start early and have the pace determined by the data or, on the contrary, to wait for definitive signs that inflation has reached the target and then set a path for rate cuts. With the first option, there is a risk of inflation not falling as expected, especially due to supply-side factors, which could complicate the last mile. In the second case, meanwhile, the risks of second-round effects and those associated with a challenging geopolitical environment (Middle East, US elections, etc.) are minimised, but on the other hand there is a risk of being too heavy on the brakes.

Therefore, the key for this year is whether the resilience of the world economy will also meet the second definition of the Royal Spanish Academy: «ability of a material, mechanism or system to regain its initial state when the disturbance to which it had been subjected has ceased». This normalisation will depend on the ability of economic policy (monetary and fiscal) to adjust demand to a supply that continues to digest the effects of geopolitical uncertainty, changes in the labour market and the widespread pursuit of strategic autonomy.

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